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Recommendations for Amendment of Federal Tax Laws

American Institute of Accountants. Committee on Federal Taxation

Recommendations for Amendment of Federal Tax Laws

Committee on Federal Taxation
American Institute of Accountants

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AMERICAN INSTITUTE OF ACCOUNTANTS

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American Institute of Accountants
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THE NATIONAL ORGANIZATION OF CERTIFIED PUBLIC ACCOUNTANTS
270 MADISON AVENUE, NEW YORK 16, N. Y.

April 4, 1950

COMMITTEE ON WAYS AND MEANS
House of Representatives
Washington 25, D. C.

Dear Sirs:

The American Institute of Accountants, through its Committee on Federal Taxation, submits herewith recommendations for revision of the Federal tax laws which it believes should be considered and acted upon at this session of Congress. The Committee believes that there is urgent need for immediate consideration of these matters.

Traditionally, the Committee does not concern itself with tax rates or the rate structure. It has directed its attention to specific provisions of the statutes, and interpretations thereof, which have created gross inequities among taxpayers and taxpayer groups. These inequities on occasion are the result of application of statutory provisions to unforeseen situations and circumstances. Sometimes they are the result of faulty draftsmanship or of judicial interpretations which seem at variance with Congressional intent, and sometimes they result from erroneous interpretations by the Treasury which can be rectified only by legislation.

Most of these recommendations have little budgetary significance, but a few would have a substantial effect on revenue. However, in our opinion, the damage suffered from the situations to be corrected far outweighs the apparent cost of rectifying them. In some cases it is urged that the amendatory recommendations be made retroactive to all open years. In other recommendations it is requested they be made effective only for the current and subsequent years.

The accounting profession is becoming increasingly concerned with variations between rules imposed upon taxpayers for the determination of taxable income and principles developed by the accounting profession for the business community, in many cases with the cooperation and approval (and indeed sometimes under the mandate) of Federal and State governmental agencies. Recommendations Numbers 1, 3, 4, 5, and 7 are examples presented for remedial legislation. Controversies on accounting matters, so frequently concerned merely with the fiscal period for recognition of income or deductions, have little long-range revenue significance directly, but they impose an enormous burden on the community and on the Treasury in time, manpower, and irritation. With the tax burden so heavy, as it must be, such "overhead" wastes are of vital concern.

The Committee desires to emphasize that, beyond the adoption of such technical corrections as the circumstances may indicate, there is a fundamental need for a complete overhauling of our Federal tax laws and a reconstruction and recodification along simple lines, expressing a permanent policy of Federal taxation, that would remove the necessity for continuous technical changes which make it difficult for taxpayers, practitioners, and administrators to obtain a working acquaintance with the law. Such an objective would include simplification of language as well as of technical structure.

Toward this end, the American Institute of Accountants has long urged the creation of a non-partisan commission composed of representatives of the legislative and administrative branches of Government, and of accountants, lawyers, and representatives of important economic groups which, free from consideration of current legislative problems, could be expected to complete a job of this magnitude. The American Institute of Accountants continues to urge the establishment of such a commission.

The Committee's recommendations made herein do not cover the whole gamut of items requiring legislative correction, but represent the results of the Committee's study and research up to the time of this submission. Problems of revenue revision are receiving the Committee's continuous attention, and from time to time, when further recommendations are formulated, they will be submitted to the Congress.

Respectfully submitted,
MARK E. RICHARDSON, *Chairman*
Committee on Federal Taxation
THOMAS J. GREEN, *Chairman*
Subcommittee on Current Tax Legislation

SUMMARY OF RECOMMENDATIONS

1. Accounting for income tax purposes should be brought into closer conformity with generally accepted accounting principles by enacting legislation covering at least the four matters set forth below. [*page 8*]

   (a) *Prepaid income*

   Deferment of reporting of prepaid income in accordance with generally accepted accounting principles should be authorized in cases where such procedure is called for by the method of accounting consistently employed by the taxpayer.

   (b) *Accrual of property and other taxes*

   Taxpayers should be permitted to deduct tax accruals, in accordance with generally accepted accounting principles consistently employed by them, ratably over the period for which the taxes are imposed.

   (c) *Apportionment of taxes between vendor and vendee*

   Property taxes should be deductible by vendor and vendee of real property in the amounts apportioned to each in accordance with local practice or statute.

   (d) *Estimated expenses and losses*

   Deduction should be allowed for all estimated expenses and losses applicable, under generally accepted accounting principles, to the income of the taxable year, the reasonableness of which can be established by the past experience of the company or of comparable companies or businesses, or by the facts of the situation.

2. Taxable income should not be attributed to gain on sale of a home if the proceeds of sale are reinvested in a new home within a reasonable time after such sale, or if a new home is purchased within a reasonable time prior to such sale with the expectation that the proceeds are to be used for such purchase. [*page 15*]

3. Non-recognition of gain on involuntary conversions, provided in Section 112(f) of the Code, should be extended to replacements made in anticipation of the receipt of proceeds of the involuntary conversion. [*page 15*]

4. The definition of "fiscal year" should be extended to include annual accounting periods consisting of multiples of weeks instead of months (such as 13 four-week periods, etc.). [*page 16*]

5. Taxpayers should be given an annual option either to capitalize or to deduct currently expenditures for research and development,

such option to determine the future tax treatment of such expenditures. [*page 17*]

6. Section 102 should be amended to provide [*page 18*]:
   (a) At taxpayer's option, dividends paid after the end of the taxable year, but before the due date (original or extended) of the tax return, should be allowed as a credit in computing undistributed Section 102 net income.
   (b) In the event of imposition of surtax under Section 102, the corporation should be permitted to relieve itself of such tax, in whole or in part, by a deficiency dividend under conditions and procedure now prescribed in Section 506 for personal holding companies, or, alternatively, by filing consent dividend papers, as provided in Section 28, effective as of the original taxable year.
   (c) The excess of net long-term capital gains over net short-term capital losses should be excluded from Section 102 net income.
7. The basis of property should not be reduced by excessive depreciation which resulted in no tax benefit. [*page 20*]
8. The limitations of Section 24(c) should not apply to deny deduction to an accrual basis taxpayer of unpaid expenses and interest if the person to whom the payment is made elects to include such payment in a taxable year beginning not later than the end of the taxable year of the payor during which the payment accrued. [*page 22*]
9. Where the holder of a mortgage or other debt forecloses on the security or collateral, and himself bids in the mortgaged or pledged property, the fair market value of the property thus bid in should be treated as a payment on account of the debt, and the deductibility and time of deductibility of the balance of the debt should be determined under the usual rules applicable to deduction of debts worthless in whole or in part. [*page 22*]
10. The right to the use of the Last-In-First-Out method of inventory (LIFO), denied to most retailers by discriminatory and improper interpretation of the Internal Revenue Code by the Bureau of Internal Revenue, should be restored by appropriate legislation, giving the right to such retailers to use the Last-In-First-Out method of valuing inventory retroactively from January 1, 1941. [*page 23*]
11. Section 23(k) of the Internal Revenue Code should be amended to exclude from the definition of non-business bad debt those debts which arise in the course of a taxpayers' trade or business, or which represent loans or advances to business organizations in which the

taxpayer has a financial interest, either as an employee, stockholder, or creditor. [*page 24*]

12. The method of taxing annuities should be revised so as to treat as income so much of each year's annuity receipts as represents a ratable portion of the difference between the cost of the annuity contract and the aggregate of the annuity payments that would be received if the annuitant lived out his life expectancy as set forth in a standard mortality table. [*page 25*]

13. Partners and sole proprietors should be includible in pension and similar plans exempt under Section 165. [*page 25*]

14. The provisions of the Code with respect to interest on deficiencies and overassessments should be amended to provide for consistent treatment between deficiencies and overassessments. [*page 26*]

15. Section 322 (b)(3) should be amended so as to make it clear that the period of limitation on filing claims for refund and credit provided therein is an additional period in the event that the periods of limitation provided under Section 322 (b)(1) and (b)(2) have expired and also to make it clear that the period of limitation under (b) (3) does not supersede the periods of limitation under (b)(1) and (b)(2). [*page 27*]

16. The basis of property, acquired by gift but subjected to estate tax in the estate of the donor, should be the same as in the case of property passing by death and not previously made the subject of a gift. [*page 29*]

17. When loss on the sale of property is disallowed by reason of the relation of the parties, the subsequent basis of the property for purpose of determining gain should be the transferor's basis. [*page 30*]

18. In the case of employees' stock purchase options, there should be treated as compensation income to the employee an amount equal to the spread between the option price and the market value at the time the option right becomes the property of the employee, or at the time the employee may first exercise the option, or at the time of exercise or sale of the option, whichever is the lesser, but in no event should such amount exceed the proceeds of sale of the option, if sold. Such compensation income should not be included in taxable income until the employee sells the stock or option, provided the option price is approximately equal to the fair market value of the stock on the date of the option agreement. [*page 30*]

19. Section 122(d)(5) provides (for taxpayers other than corporations) for allowance of losses in the computation of net operating loss

deduction only if they are attributable to the operation of a trade or business regularly carried on by the taxpayer. The Section should be amended to provide for recognition in the computation of net operating loss deduction of losses on disposal of assets used in a trade or business by a non-corporate taxpayer. Such losses on sales by the estate of a deceased taxpayer, and operating losses by the estate in conducting business, should be allowed as carry-backs to taxable years of the deceased. [*page 32*]

20. Recommendations with respect to personal holding companies. [*page 33*]

    (a) Effectuation of deficiency dividends by consent dividend procedure should be authorized.

    (b) Deficiency dividend procedure should not be denied in cases of non-fraudulent delinquency in filing personal holding company tax returns.

    (c) The deduction of the federal income tax, in computing undistributed subchapter A net income, should be clearly stated to be the tax for the taxable year, whether the corporation is on the cash basis or the accrual basis.

21. The present double taxation of corporate income—once to the earning corporation, and again to the stockholders upon distribution of such income as dividends—should be mitigated and eventually eliminated. This double taxation has two aspects: (a) tax on intercorporate dividends and (b) tax on dividends paid to non-corporate shareholders without credit either to the corporation or to the shareholder. The tax on intercorporate dividends should be eliminated. Non-corporate shareholders should be allowed a credit against individual income tax of a percentage of dividend income equal to the initial combined rate of normal tax and surtax on individuals, such credit not to exceed the tax, otherwise determined, after applying the credits provided in Sections 31 and 32 but before applying the credit provided in Section 35 of the Internal Revenue Code. [*page 35*]

22. The 2 per cent additional tax applicable to consolidated returns should be eliminated. [*page 36*]

23. The "notch" provision under which corporate income between $25,000.00 and $50,000.00 is taxed at 53 per cent as compared with the 38 per cent applicable to income in excess of $50,000.00, should be eliminated, and all corporate incomes, regardless of size, taxed on a graduated rate scale up to $50,000.00 and at a flat rate thereafter, the rate applicable to any income bracket to be no greater than the flat rate. [*page 36*]

24. Where a corporation is formed or availed of to acquire the assets and become the successor, in a tax-free reorganization, of a predecessor corporation, which, in pursuance of the plan, is liquidated and dissolved, the successor corporation should step into the "tax shoes" of the predecessor corporation for the purpose of permitting carry-back and carry-forward of net operating losses from one to the other, and application of the tax benefit rule to recoveries by the successor on losses or deductions previously claimed or allowable to the predecessor, and so as to permit full deductibility by the successor of any payments or charges which would have been deductible by the predecessor had the predecessor continued in existence. [*page 37*]

25. For the purpose of Section 23(g)(4), which excludes from the capital loss category, loss from worthlessness of stock in a virtually wholly owned subsidiary of a domestic corporation, if more than 90 per cent of the subsidiary's gross income for its entire history was from other than investment sources, gross income from the sale of merchandise, stock in trade, or property held primarily for sale to customers in the ordinary course of the trade or business, should be defined to mean "gross receipts" from such sales. [*page 38*]

26. A transfer of substantially all the assets of a corporation to another corporation should not be disqualified as a "reorganization" under Section 112(g)(1)(C) merely because the voting stock received in exchange is that of a parent company of the transferee corporation. [*page 38*]

27. The definition of reorganization in Section 112(g) should be broadened to bring within its scope "spin-off" and "split-up" transfers. [*page 39*]

28. Recommendations re mitigation of effect of statute of limitations. [*page 39*]

RECOMMENDATIONS

1. Accounting for income tax purposes should be brought into closer conformity with generally accepted accounting principles by enacting legislation covering at least the four matters set forth below.

Ever increasing divergences between rules of accounting for tax purposes (as prescribed by regulations, rulings, and court decisions), on the one hand, and generally accepted accounting principles (as universally applied in determining net income for commercial management and investment purposes), on the other hand, has been and continues to be the despair of businessmen, accountants, and tax practitioners alike. Such divergences not infrequently result in taxing as income what is actually capital. They are a continuous source of irritating adjustments of tax returns which, in the long run, yield no revenue to the government, because they merely represent shifts of income between years. The advantages, in terms of simplicity, of maximum conformance of tax accounting with the accounting methods employed in the taxpayer's accounting records, and in the preparation of his financial and credit reports, are self-evident.

There is no question but that it was the basic intention that generally accepted accounting principles be applicable for tax purposes. Thus Section 41 of the Code provides that

> "The net income . . . shall be computed in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but . . . if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

The regulations (Reg. 111) provide:

> "Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income. This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer." (Sec. 29.21-1)

> "If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for." (Sec. 29.41-1)

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." (Sec. 29.41-2)

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose." (Sec. 29.41-3)

The Supreme Court, in the leading case of *U. S.* v. *Anderson,* 269 U. S. 422 (1926) in referring to the original statutory forerunner of the above quoted excerpts from Section 41, and to an early Treasury Decision to the same effect, stated:

> "It [the Treasury Decision] recognized the right of the corporation to deduct all accruals and reserves without distinction made on its books to meet liabilities, provided the return included income accrued and, as made, reflected true net income . . . It [the purpose of the statute] was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during a taxable period, the expenses incurred in and properly attributable to the process of earning income during that period."

In this statement, the Supreme Court not only succinctly and accurately stated the primary objective of all generally accepted accounting principles—to have each accounting period reflect the income *earned* in that period and the expenses incurred in and properly attributable to the process of earning that income—but, what is even more important, recognized that it was the purpose of the taxing statute to give effect to these principles, and, to that end, to permit taxpayers "to deduct all accruals and *reserves* without distinction made on its books to meet liabilities."

However, in the twenty-four years following the *Anderson* decision, judicial interpretations of that decision and of the later decision in *North American Oil Consolidated* v. *Burnet,* 286 U. S.

417 (1932), have resulted in distortions of and departures from the scientific accounting principles, recognition of which the *Anderson* decision had declared to be the purpose of the taxing statute.

These distortions and divergences have occurred chiefly in the four directions set forth below:

(a) *Prepaid income:*

> Deferment of reporting of prepaid income in accordance with generally accepted accounting principles should be authorized in cases where such procedure is called for by the method of accounting consistently employed by the taxpayer.

Payments received in advance for the use of property in future years or for services to be rendered in future years should be included as income in the future years to which applicable and not in the year of receipt. This is well-recognized and established accounting procedure. It is only in this way that income such as rentals, publication subscriptions, and club dues, etc., can be clearly reflected by including the income in the period in which it is earned and in which are incurred the costs and expenses of earning it. In fact, until such expenses and costs are incurred in the future period, it cannot be known whether the advance receipts of rentals, etc., will represent a net income or a net loss.

However, the Courts have held that income received in advance is nevertheless taxable in year of receipt, even where there is a continuing obligation to perform services and incur expenditures over a period of time in order to earn the income, and despite the fact that generally accepted accounting principles, and the accounting methods consistently employed by the taxpayer, call for the deferment of the reporting of such income until the period or periods in which such income is earned by the rendering of the services and the incurring of related expenditures. This has created all sorts of absurd tax results, arising out of the basic difficulty that net income is bound to be distorted if the income is required to be included in one period, while the related expenditures are included in a later period.

This distortion is accentuated by the fact that, in contrast to their treatment of income, the Courts require that expenses paid in advance or which benefit future periods be not permitted as deductions in the year of payment or accrual, but only in the future years to which the expenses are applicable.

A striking example of such distortion occurs where a landlord, employing the accrual method of accounting, in order to finance the payment of the broker's commission on a long-term lease, arranges for the payment in advance of rentals applicable to the last few years of the lease. The decisions have held that the rental thus received in advance must be included in taxable income in the year of receipt, whereas the broker's commissions, which such advance rentals were intended to finance, may not be deducted in the year of payment, but must be spread over the life of the lease. In such cases the result frequently is an abnormally large and unreal taxable net income in the first year of the lease, and equally unreal losses in the last few years of the lease—not by reason of any actual variations in results of operations, but solely by reason of the artificial accounting procedure enforced for tax purposes.

Deferment of reporting of prepaid income in accordance with generally accepted accounting principles should be authorized in cases where such procedure is called for by the method of accounting consistently employed by the taxpayer.

(b) *Accrual of property and other taxes:*

Taxpayers should be permitted to deduct tax accruals, in accordance with generally accepted accounting principles consistently employed by them, ratably over the period for which the taxes are imposed.

It is universally accepted accounting practice to regard taxes as an expense of the period for which levied. Thus if a property tax is imposed for the calendar year 1950, it is regarded as an expense of that calendar year, regardless of local peculiarities of assessment or lien dates, and if, for example, the taxpayer should be on a fiscal year ending May 31st, 5/12 of such tax would be included as an expense for the year ended May 31, 1950, and 7/12 would be included as an expense for the year ended May 31, 1951. Again, if a corporation franchise tax based upon the income of a given period should be imposed for the privilege of carrying on business for a future period, the accepted accounting practice would be to treat such tax as an expense of the privilege period for which the tax is imposed.

Under the court decisions, however, it is held that accrual of a tax occurs upon the date when the amount and liability for the tax become fixed and that the entire tax is deductible on, and only on, that single date. Thus, in many jurisdictions, the amount and liability for a property tax for the calendar year 1950 would be fixed some time late in 1949, and, under such court decisions, would be deductible, on the accrual basis, only at that time, whereas in other jurisdictions, the amount and liability for the tax for 1950 would not be determined until some time in 1950 and would be deductible only on that date. Where the income tax year of the taxpayer varies from the property tax year of the local jurisdiction, many other peculiar variations ensue.

The result has been an utterly confusing pattern, in which deductibility of taxes varies from community to community, depending upon the local peculiarities of assessment date, date of issuance of assessment rolls and tax warrants, lien dates, date upon which personal liability for the tax is determined, etc. In many cases, several property taxes on the same property may be deductible at different dates because of varying assessment and lien dates relating to the village, county, school, and other property taxes imposed in the community.

All of this serves no real practical purpose, since all that is involved is a shift of deductions between years. Consistency in practice and relation of expenses to the period for which imposed are the important factors in clearly reflecting income. The artificial rules created by the aforesaid court decisions are not even in accord with local practice (and sometimes local statute) with respect to the apportionment of taxes between vendor and vendee, which is universally based on a prorating of taxes over the period for which imposed.

These comments are not intended to cover taxes, the liability for which is contingent, denied and contested by the taxpayer.

Taxpayers should be permitted to deduct tax accruals, in accordance with generally accepted accounting principles consistently employed by them, ratably over the period for which the taxes are imposed.

(c) *Apportionment of taxes between vendor and vendee:*

Property taxes should be deductible by vendor and vendee of real property in the amounts apportioned to each in accordance with local practice or statute.

Local practice in all communities is to apportion property taxes between vendor and vendee, upon a sale of real property, by prorating the tax over the tax year for which the tax is imposed. In some cases, such procedure is provided by local statute. Such apportionment is made without reference to assessment dates, lien dates, existence of personal liability for the tax, etc., but is made wholly by reference to the tax year for which the tax is levied.

In many jurisdictions, however, a property tax for the calendar year 1950 would, by reason of the local statutes, have been assessed and become a personal liability of the property owner and a lien upon the property on or before January 1, 1950. In such circumstances, the Supreme Court held, in *Magruder* v. *Supplee,* 316 U. S. 394 (1942), that the vendee who purchases property, for example, after January 1, 1950—even on January 3, 1950—and, therefore, pays practically the entire 1950 tax, cannot deduct such tax, because it was not imposed upon him, but was a personal liability of the vendor and a lien upon his property prior to the sale. The vendee, says the Court, is not permitted the deduction because the tax payment by him merely discharges an existing lien upon the property and is therefore a part of his cost. At the same time, however, the vendor may not deduct the tax because he did not pay it.

This is not only an artificial and distorted result, but does complete violence to real estate practice which has been in existence long before the income tax came on to the statute books.

The statute should be amended to provide for deduction of property taxes by vendor and vendee in accordance with the amounts thereof apportioned to each, if such apportionment is pursuant to local practice or statute in that respect.

(d) *Estimated expenses and losses:*

Deduction should be allowed for all estimated expenses and losses applicable, under generally accepted accounting principles, to the income of the taxable year, the reasonableness of which can be established by the past experience of the company or of comparable companies or businesses, or by the facts of the situation.

In applying the basic principle of accounting for income, namely, that of including expenses and losses in the period in which is earned the income to which they relate, it is generally accepted practice to provide by estimates for expenses and losses relating to the accounting period and which are reasonably determinable in amount. Such estimates, at least to the extent that experience and surrounding circumstances establish their reasonableness, should be allowed as deductions.

Thus, where accounts receivable are outstanding at the end of a period, it is accepted accounting practice to deduct the estimated loss for the cash discounts which, experience has shown, will be taken by the customers on payment. It has been held, however, that such a loss may not be deducted, because, until the customers actually pay the accounts, it is not known which customers will, and which will not, pay in time to be entitled to the discount—this, despite the fact that experience over a period of years may establish that, with comparatively little variance, a determinable percentage of the customers takes advantage of the discounts. Again, if merchandise is sold under a guarantee, or with an agreement to service or repair the product for a given period, past experience frequently indicates the amount of future repair and service expense, or losses on guarantees on such sales, with a high degree of accuracy, and proper accounting procedure would require that estimates for such future expenses and losses arising out of such sales should be deducted in determining the income realized therefrom. Nevertheless, for the same reasons as in the case of the cash discounts, such items are not allowed, and deduction therefor is not permitted until the period or periods in which the losses are sustained or the repair and service expenses incurred. Under these conditions, the taxpayer is always being subjected to tax on an amount of income, which, in fact, is not income, but capital.

Deduction of such losses is at present permitted by statute in the case of bad debts. The basis of such statutory authorization was generally accepted accounting practice.

This principle should be extended to estimates for all expenses and losses applicable, under generally accepted accounting principles, to the income of the taxable year, the reasonableness of which can be established by the past experience of the company or of comparable companies or businesses, or by the facts of the situation.

This recommendation is not intended to be applicable to "Reserves'' as employed by special classes of taxpayers like insurance companies, nor is it intended to cover provisions for unrealized decrease in value of property, for contingencies, or for items the liability for which is contested by the taxpayer.

2. **Taxable income should not be attributed to gain on sale of a home if the proceeds of sale are reinvested in a new home within a reasonable time after such sale, or if a new home is purchased within a reasonable time prior to such sale with the expectation that the proceeds are to be used for such purchase.**

Section 112 of the Internal Revenue Code provides that if property held for productive use or investment is exchanged for property of a like kind held either for productive use in trade or business or for investment, no gain or loss shall be recognized. No gain is recognized in excess of the amount of money or other property received in exchange.

If an individual sells a home, because he is required to move to a new location or for some other reason, he cannot deduct any loss realized and further he must pay tax on gain realized regardless of the fact that he reinvests all of the proceeds of sale in a new home.

Section 112 should be amended to provide that no gain or loss shall be recognized if proceeds of sale of a home are invested in another home within a period six months prior to or subsequent to the date of sale, except to the extent that such proceeds exceed the amount invested in the new home. The provisions of Section 113(a)(6) should be made applicable to determination of the basis for determining gain on sale of a home acquired under circumstances described above.

3. **Non-recognition of gain on involuntary conversions, provided in Section 112(f) of the Code, should be extended to replacements made in anticipation of the receipt of proceeds of the involuntary conversion.**

Under Section 112(f), if property is involuntarily converted into money, as by fire and receipt of insurance proceeds, or by condemnation and receipt of condemnation award, no gain is recognized, even if the proceeds exceed the adjusted basis of the property, if the proceeds are used forthwith to replace the property with other property similar or related in service or use, or in the establishment of a replacement fund for that purpose. However, under the court decisions, this applies only if the particular moneys received as proceeds of the involuntary conversion are expended in the acquisition of such similar property or in the establishment of a replacement fund. In many cases, months and sometimes years elapse between the time of the destruction or condemnation of the property and the receipt of the insurance proceeds or condemnation award. If, in anticipation of the receipt of such proceeds, the taxpayer should spend an equivalent or greater amount in the acquisition of similar property, out of its own or funds borrowed for the purpose (to be replaced or repaid out of the conversion proceeds) the court decisions hold that the non-recognition provisions of Section 112(f) do not apply. This defeats the underlying purpose of Section 112(f), since in most cases it is utterly impractical for the taxpayer to wait, and perhaps to suspend business operations, until the conversion proceeds are received.

Accordingly, this section should be amended to make it clear that replacements within the purview of the statute are governed by its provisions, even if made in anticipation of the receipt of the conversion proceeds. This amendment should be made applicable retroactively to all open years.

4. The definition of "fiscal year" should be extended to include annual accounting periods consisting of multiples of weeks instead of months (such as 13 four-week periods, etc.).

Use of four and five-week periods rather than monthly accounting periods has been consistently followed by many trades and industries in an effort to make more accurate cost distributions, and financial comparisons, which would otherwise be disturbed by use of months that vary from 28 to 31 days. It has been the only possible method of accurately reflecting costs in many industries and businesses. In certain businesses, such as meats, groceries and other retail stores, the packing industry, the baking industry, and others, merchandising is handled on a weekly basis, making weekly closing of accounts the only practicable procedure. A natural corollary of this method of accounting is for annual accounting on a thirteen four-week period basis, or by using twelve periods of which eight are four weeks in length, and four are five weeks in length. Under this procedure, determination of the end of the week, or the end of the year, is simply a matter of selecting the most practical day for closing. In most businesses, it is Saturday night of the fourth week. In others, it may be a Monday night, etc. In these cases, an additional week is included in the annual period every five or six years in order to compensate for the difference between an actual year and 52 weeks. Such use of accounting periods, consisting of multiples of weeks, is a common and generally accepted business and accounting practice.

Prior to the decision in the case of *Parks-Chambers, Inc.* (131 Fed. (2) 65, affirming 46 B.T.A. 114), it had been understood that the Bureau approved this practice, provided it clearly reflected income and was adopted in conformity with good business practice. Under said decision, use of the thirteen four-week period (or the indicated alternatives) is barred for tax reporting purposes. Use of such periods was held to mean that the taxpayer had not elected a fiscal year, because the selected period did not end on the last day of a month, with the result that, unless the thirteen four-week period just happened to end on the last day of a month, the calendar year must be used for tax purposes in utter disregard of the taxpayer's actual annual accounting period.

Such methods of accounting by which 52 consecutive weeks (and occasionally 53 weeks) are represented in each fiscal year should be approved. There is no practical reason to the contrary. It is a serious problem for long established businesses, whose accounting methods have been repeatedly approved in Bureau examinations, to have to alter methods of keeping books, reports to stockholders and credit agencies, cost accounting systems and other extremely detailed record-keeping processes.

The law should be amended *retroactively* to include within the definition of "fiscal year" any annual period consistently employed by the taxpayer, if the taxpayer uses the system of dividing its annual accounting period into four-week periods or four and five-week periods, instead of calendar months.

5. Taxpayers should be given an annual option either to capitalize or to deduct currently expenditures for research and development, such option to determine the future tax treatment of such expenditures.

In general, a taxpayer is allowed to deduct ordinary and necessary expenses but not expenditures for improvements or betterments. Most taxpayers charge off all research and development expenditures against income as they are incurred. Some taxpayers, however, capitalize major expenditures for such purposes and amortize the expenditures over a specified period, usually arbitrarily determined.

The Commissioner has often disallowed many of these expenditures, treating them as capital expenditures, and the controversy between taxpayer and Commissioner has to be settled by compromise because the attitude of the courts in such situations is uncertain. Where the expenditure is capitalized by the taxpayer, whether voluntarily or involuntarily, the problem arises as to the period over which the capitalized items should be amortized or written off against income. The adoption of an established policy as to the treatment of research and development expenditures would be in the public interest.

Accordingly, it is recommended that Section 24(a)(2) be amended to provide that a taxpayer shall have the option either to capitalize or to deduct when incurred as an ordinary and necessary expense any expenditures for research and development except for a capital expenditure for tangible property. A separate option should exist for each year's expenditures or for each research or development project, but once the option is exercised for any year's expenditures or project it should be final. Where such expenditures or projects are capitalized, the rate of amortization should be determined by the taxpayer, but once fixed as to a particular year's expenditure it should be final for the year of expenditure and for future years unless the project is disposed of or abandoned.

Any capital expenditures incurred as a result of research and development of tangible property should be capitalized but in an amount not to increase the tax basis of such property above its fair replacement value or fair market value, whichever is lower. Where the property is subject to wear and tear, etc., such expenditures should be recoverable through ordinary depreciation rates under Section 23(1).

If a research or development project, or if resulting tangible property is disposed of or abandoned in a future year, the profit or loss on such disposal or abandonment should be treated in accordance with Section 117(j).

6. Section 102 should be amended to provide:

(a) At taxpayer's option dividends paid after the end of the taxable year, but before the due date (original or extended) of the

tax return, should be allowed as a credit in computing undistributed Section 102 net income.

(b) In the event of imposition of surtax under Secton 102, the corporation should be permitted to relieve itself of such tax, in whole or in part, by a deficiency dividend under conditions and procedure now prescribed in Section 506 for personal holding companies, or, alternatively, by filing consent dividend papers, as provided in Section 28, effective as of the original taxable year.

(c) The excess of net long-term capital gains over net short-term capital losses should be excluded from Section 102 net income.

High corporate profits during the postwar period combined with high individual tax rates have unquestionably created some situations to which Section 102 should be applied. These are cases in which the accumulation of earnings in the corporation is clearly beyond all reasonable needs of the business and is motivated by a purpose to save taxes to the shareholders.

In many other cases, however, corporations with a temporary, highly abnormal liquidity find themselves under powerful silent pressure from Section 102 to pay dividends when considerations of normal business prudence would require conservation of these funds for additions to and replacements of facilities, expansion, protection against possible business decline, or other valid purposes. With the return of competitive business conditions, the need for greater working capital is more evident (with prices far above prewar levels, inventories and receivables reflect dollar amounts far larger than prewar amounts, even for the same physical volume). The increasing tendency reflected in some court decisions to restrict justification for retention of earnings to business requirements which are imminent and definite, as well as the fact that the burden of justification of retaining earnings is on the taxpayer, exerts pressure toward unsound dividend policy. Directors, acting in good faith and using their best judgment, may find their judgment held to be erroneous by the Commissioner or by the courts (who have the benefit of hindsight) and thus be exposed to minority stockholders' actions.

This pressure and the uncertainty which it creates in the formulation of sound business policy is the most unfortunate feature of the present situation.

Under our present system of taxing dividends, the principle of Section 102 is undoubtedly necessary. It would appear that assurance of a wise and sympathetic administration of the Section is equally necessary. Announcement of an administrative policy to apply Section 102 only in clearly flagrant cases, or where dividend history over a number of years clearly indicates tax-motivated non-distribution of earnings, and that the taxpayer would receive the benefit of any reasonable doubt, might help considerably to relieve existing confusion and uncertainty.

Nevertheless, if the burden of proof is to remain on the taxpayer and not be shifted to the Commissioner, then the taxpayer should be permitted to relieve itself of the imposition of the tax, in whole or in part, by the methods recommended. In that manner, the taxpayer would be permitted to take advantage of the same hindsight which is now available to the Commissioner and the courts.

Likewise, the application of the Section 102 surtax to long-term capital gains is inequitable. Such income, when realized by a corporation, is taxed at the same maximum rate at which it would be taxed if realized directly by an individual. Thus, the income does not escape its proper tax burden by reason of being realized and accumulated by a corporation rather than by an individual. Since under existing law net long-term capital gains are not subject to the tax on undistributed net income imposed on personal holding companies, ordinary corporations should not be subjected to a greater burden. Finally, the Section should be amended so as not to apply to corporations whose stock ownership is broader than that stated in Section 501 relating to personal holding companies.

7. The basis of property should not be reduced by excessive depreciation which resulted in no tax benefit.

The requirement that excessive depreciation previously allowed be deducted in determining the basis of assets was included in the statute in order to prevent a taxpayer from obtaining a double deduction, with double tax benefit, of the same capital investment. However, that rule should not be applied if the excessive depreciation has resulted in no tax benefit. The reason for avoiding the inequitable result that formerly arose from the taxation of recoveries of bad debts and taxes, where no tax benefit had been obtained from the original deduction, is equally applicable to excessive depreciation.

Section 113(b)(1)(B) of the Internal Revenue Code provides that, in determining the basis of property, "proper adjustment in respect of the property shall in all cases be made . . . in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws . . ."

From the Bureau's own instructions it appears that "where it is clearly evident that no taxable income will be developed," the Bureau does not even attempt to judge whether the depreciation deducted by taxpayers in loss years is properly allowable, but simply postpones examinations until years which show profits. Yet, when the Bureau eventually finds that the depreciation deductions taken were improper and excessive, it contends that its own failure to examine a "loss return" at the proper time constitutes an "allowance" and approval of such improper and excessive deductions taken by the taxpayer.

The legislative history of Section 113(b)(1)(B) clearly discloses that Congress introduced the distinction between "allowable" and "allowed" without any thought of changing the law in force prior to 1932, being intent solely upon codifying the already well-established equitable principle of estoppel. (See Sen. Rep. 665, p. 29, 72nd Congress, 1st Session; H. R. Rep. 708, p. 22, 72nd Congress, 1st Session). However, where a past error had no consequences at the time when it was committed, no inequity can have arisen, which would call for the application of any principle of estoppel. Where no tax would have been due even if the return had been correct, the Commissioner cannot obviously have "allowed" something merely by doing nothing.

Since the Bureau's position has been supported by a five-to-four Supreme Court decision in *Virginian Hotel Corporation of Lynchburg* v. *Guy T. Helvering, Commissioner of Internal Revenue* (63 S. Ct. 1260), only remedial legislation can effectively correct the situation. Such legislation should provide that the adjustment for depreciation theretofore "allowed" should be for only such part of the depreciation deductions as reduced taxes otherwise payable.

8. **The limitations of Section 24(c) should not apply to deny deduction to an accrual basis taxpayer of unpaid expenses and interest if the person to whom the payment is made elects to include such payment in a taxable year beginning not later than the end of the taxable year of the payor during which the payment accrued.**

Section 24(c) disallows to a taxpayer on the accrual basis all deductions for unpaid expenses and interest which are payable to related interests who are on a cash basis unless the payment is made during the taxpayer's taxable year or within two and one-half months after the close of such year. The purpose of this Section is to prevent a taxpayer claiming a deduction for expenses or interest payable to a related interest where the latter is not required to include the items as income.

It has been held in a number of cases that the deduction was not allowable even though the related interest, on a cash basis, was required to include the expenses as income because "constructively received."

Section 24(c), should be amended to provide that such section shall not apply where the person to whom the payment is made elects to include such payment in his return for a taxable year beginning not later than the end of the taxable year within which the payor's taxable year ends. This would be analogous to the consent dividend provision in Section 28.

9. **Where the holder of a mortgage or other debt forecloses on the security or collateral, and himself bids in the mortgaged or pledged property, the fair market value of the property thus bid in should be treated as a payment on account of the debt, and the deductibility and time of deductibility of the balance of the debt should be determined under the usual rules applicable to deduction of debts worthless in whole or in part.**

Under present Bureau regulations where a debtor bids in mortgaged or pledged property, the transaction is split into two elements: (1) the portion of the debt which was applied to the satisfaction of the bid price is compared with the fair market value of the property, with resulting gain or loss—sometimes claimed to be capital gain or loss (in one case where not only principal, but also interest on the debt, was applied towards satisfaction of the bid price, the Supreme Court held that interest income resulted); (2) the deductibility of the balance of the debt, not applied to the bid price, is determined under the usual rules relating to debts worthless in whole or in part, depending upon whether there is enforceable personal liability, other collateral, guarantees, etc. Particularly where it is claimed that the first element results in capital gain or loss, distorted results frequently ensue.

Actually all that has happened is that the debtor has received as against his investment in the debt, property having a certain fair market value, leaving the balance of the investment in the debt to be recouped. If worthless, this balance should be allowed as an ordinary bad debt deduction and should not be split artificially into two parts, according to the accident of the bid price, which, usually because of absence of competing bidders, frequently fails entirely to reflect true values or the realities of the situation.

10. The right to the use of the Last-In-First-Out method of inventory (LIFO), denied to most retailers by discriminatory and improper interpretation of the Internal Revenue Code by the Bureau of Internal Revenue, should be restored by appropriate legislation, giving the right to such retailers to use the Last-In-First-Out method of valuing inventory retroactively from January 1, 1941.

Remedial legislation is necessary to correct a discrimination against a large segment of American retail industry which has persisted since 1941. This injustice has resulted from an improper and discriminatory interpretation of the Internal Revenue Code by the Bureau of Internal Revenue respecting the right of retailers to the use of the Last-In-First-Out method of valuing inventory provided by Section 22(d) of the Code.

The Hutzler Brothers Company decision of the Tax Court, handed down early in 1947, invalidated the Bureau's erroneous interpretation, but under regulations presently in effect, only those retailers who acted in contravention of the position of the Bureau of Internal Revenue and contested such Bureau position are entitled to the elective method provided by Congress and confirmed by the Hutzler decision. Those retailers who obeyed the interpretation of the Bureau of Internal Revenue have therefore been penalized.

The Bureau has recently denied relief to these taxpayers by an assertion that it (the Bureau) could not remedy this discrimination by administrative action. The Treasury has stated, "It has been concluded accordingly that no revision of the regulations . . . will be undertaken by the Department so long as the statutory provisions involved are retained in their present form."

While retailers have been permitted, by reason of the revision of the Bureau's regulations in 1948, to adopt the LIFO method from the year 1947 forward, the large group of retailers who were misled by the Bureau's original erroneous position are not now permitted to adopt the LIFO method retroactively to 1941 although all other types of taxpayers were permitted for the years 1941 through 1946, inclusive, the use of the LIFO method.

Since the Bureau has now admitted the validity of the application of the LIFO method to retail taxpayers, and has denied the right to retailers to use the LIFO method retroactively to 1941 only because such taxpayers did not meet the statutory requirement pertaining to the reports to shareholders and creditors, and because such taxpayers did not meet the Bureau's regulatory requirements governing time and manner of election of method, such discrimination must be eliminated by giving to the discriminated-against retailers the right to use the LIFO method retroactively to January 1, 1941. If Section 22(d) had been fairly and properly interpreted by the Bureau in 1941, the discrimination against retailers would not have taken place. To treat all taxpayers fairly, legislation should retroactively provide for LIFO for retailers to January 1, 1941.

11. Section 23(k) of the Internal Revenue Code should be amended to exclude from the definition of non-business bad debt those debts which arise in the course of a taxpayer's trade or business, or which represent loans or advances to business organizations in which the taxpayer has a financial interest either as an employee, stockholder, or creditor.

The present statutory definition of non-business bad debt has been interpreted by the Treasury Department to exclude those debts which arose in the course of a trade or business but which at the time of worthlessness are not directly connected with a trade or business of the taxpayer suffering the loss. Classification on the basis of circumstances when the debt was incurred would be a more equitable test.

Furthermore, considerable controversy and litigation has ensued as to the classification of bad debts incurred by employees and investors on loans and advances to business organizations by which they are employed or in which they have a financial interest. The present attitude of the Treasury Department puts a premium on form rather than on substance, and inhibits necessary flexibility of business dealings.

The first part of the proposed amendment should be effective for debts becoming worthless after December 31, 1949, and the second part should be effective for all open years.

12. The method of taxing annuities should be revised so as to treat as income so much of each year's annuity receipts as represents a ratable portion of the difference between the cost of the annuity contract and the aggregate of the annuity payments that would be received if the annuitant lived out his life expectancy as set forth in a standard mortality table.

Under Section 22(b)(2), I.R.C., the taxpayer receiving an annuity is taxed on an amount equal to 3 per cent of the cost, the remainder being treated as a recovery of capital. Under this method of taxing annuities, the chance of recovering capital tax-free during the lifetime of a taxpayer is remote, particularly since most annuity contracts now in existence are based upon a lower interest yield than 3 per cent.

Section 22(b)(2), I.R.C., should be amended to provide that the principal of the annuity payments shall be computed by spreading the cost of the annuity over the life expectancy beginning with the commencement of annuity payments and only that portion of each annuity payment which is in excess of that applicable to principal shall be included in gross income.

13. Partners and sole proprietors should be includible in pension and similar plans exempt under Section 165.

Stockholder-employees, even when they are major or sole stockholders, can be included, subject to certain limitations, in pension plans qualifying under Section 165, contributions to which are currently deductible by the corporation, with no taxability to the participants in the plan until benefits are received. Subject to the same limitations, where the business is conducted as a partnership or proprietorship, the partners or proprietor should be eligible for inclusion in such plans. Under present law, a qualified plan must be for the exclusive benefit of *employees,* which includes stockholder-employees, but not partners or proprietors, since the latter are not employees. The statute should be amended to admit partners and proprietors to participation in plans qualifying under Section 165.

14. The provisions of the code with respect to interests on deficiencies and overassessments should be amended to provide for consistent treatment between deficiencies and overassessments.

The provisions of the Internal Revenue Code dealing with the allowance of interest on overassessments (refunds) contained in Section 3771 provide a general rule that interest on overpayments (overassessments) shall be allowed at the rate of 6 per cent:

(a) *In the case of a credit;* from the date of the overpayment to the due date of the amount against which the credit is taken, but if the amount against which the credit is taken is an additional assessment, then to the date of the assessment of that amount.

(b) *In the case of a refund;* from the date of the overpayment to a date preceding the date of the refund check by not more than thirty days, such date to be determined by the Commissioner.

Although the income tax and the excess profits tax on corporations are correlative taxes computed for all practical purposes as a unit, they are as a general rule treated as independent taxes for the purpose of interest computations. As a result, the interest charge on a net deficiency of two related taxes is greater than the interest charge on a deficiency of the same amount in a single tax.

This inequity is illustrated by the following common example. Whenever there is an increase in excess profits tax with a corresponding reduction in income tax or an increase in income tax with a corresponding reduction in excess profits tax and the original tax in each instance had been paid in quarterly installments, interest adjustments are made as follows:

(a) Upon the deficiency, interest is computed from the date the original return was due, namely on the fifteenth day of the third month following the close of the calendar or fiscal year.

(b) On the other hand, interest on the overassessment is computed from the time the tax was overpaid. If the entire overpayment is applicable to the last installment (*Blair* v. *Birkenstock,* 271 U.S. 348; C.B. V-1, 142), interest is computed from the fifteenth day of the twelfth month following the close of the calendar or fiscal year. The taxpayer, under the circumstances, is overcharged to the extent of nine months' interest on the refund, purely on the basis of theoretical, if not arbitrary, bookkeeping.

In cases involving the filing of Form 874, interest should cease on the net deficiency—the excess of the deficiency over the overassessment—thirty days from the signing of the waiver and acceptance form. If it is necessary to file a revised form 874 with an increase in the net deficiency, interest should accumulate only on the increase in the net deficiency. It should be unnecessary to file separate waiver or acceptance forms in respect to the deficiency and in respect to the overassessment. Although income taxes and excess profits taxes appear in separate chapters of the Internal Revenue Code, they should be "deemed" a single tax for interest purposes.

Legislation is required to clarify the conflict resulting from the Treasury's interpretation of Section 3771(b)(1) and 292(a) where Form 874 is executed.

To prevent any abuse resulting from a long delay in tendering a refund check to the taxpayer, Section 3771(b)(2) should be amended so as to provide that if the Commissioner does not tender a check to the taxpayer within thirty days after the date of such check additional interest shall be allowed and paid.

15. Section 322 (b)(3) should be amended so as to make it clear that the period of limitation on filing claims for refund and credit provided therein is an additional period in the event that the periods of limitation provided under Section 322 (b)(1) and (b)(2) have expired and also to make it clear that the period of limitation under (b)(3) does not supersede the periods of limitation under (b)(1) and (b)(2).

Subparagraph (b)(3) was added to Section 322 of the Internal Revenue Code by Section 169(a) of the Revenue Act of 1942, applicable to taxable years beginning after December 31, 1941. The reports of the House Committee on Ways and Means and the Senate Finance Committee, in explaining the purpose and effect of Paragraph (b)(3), say that "subsection (a) of this Section of the Bill adds paragraph 3 to Section 322(b) to give the taxpayer the right to file a claim for credit or refund during the extended period and during six months thereafter, in case an overpayment is discovered after the time for obtaining credit or refund of such overpayment under the provisions of Section 322(b)(1) and (2)." Paragraph (b)(3) as drafted and as it now appears in the Code provides that where a waiver under Section 276(b) has been given by a taxpayer, i.e., where an agreement is entered into between the Commissioner and a taxpayer to extend the period of limitation on assessment of a deficiency, the period of limitation on a claim for credit or refund expires within six months after the expiration of the extended period of limitation on assessment. This provision has been construed by the Bureau to supersede, in the case of a waiver, the periods of limitation provided in Paragraphs (b)(1) and (2). Such a construction is unquestionably contrary to the intent of Congress as stated in the Committee reports. The effect of such a construction can be and often has been so grossly inequitable as to be clearly illogical.

As an illustration of the inequity of the effect of Paragraph (b)(3) as construed and applied by the Bureau, consider the status of claims for refund filed by taxpayers A and B under the respective circumstances described below:

A	*History of Cases*	*B*
March 15, 1946	Return for 1945 filed	March 15, 1946
March 1, 1949	Waiver under Sec. 276(b) filed, extending limitation on assessment until 6/30/49	None
March 30, 1949	Assessment made	March 15, 1949
March 15, 1949	Regular period of limitation on assessment expired	March 15, 1949
June 1, 1949	Additional tax assessed	June 1, 1949
June 30, 1949	Additional tax paid	June 30, 1949
January 3, 1950	Claim for refund filed	June 30, 1951

The Bureau would regard A's claim as filed too late because it was filed more than six months after the expiration of the waiver period, but would regard B's claim as timely filed, because it was filed within two years after payment of the tax, although A cooperated with the Bureau by extending the period of assessment and although the taxes were both assessed and paid on the same date.

Such peculiar and inequitable results were certainly not contemplated by Congress; just as certainly such results are contrary to the intent of Congress.

Paragraph (b)(3) should be amended so as to leave no room for doubt that it grants an additional extension of the period of limitation for filing claims for credit or refund if the periods of limitation under Paragraphs (b)(1) and (2) have expired; in other words, that the period of limitation on filing claims for credit or refund is the period under Paragraphs (b)(1) and (2) or the period of six months after the expiration of the waiver period, whichever is later. The amendment should be made retroactive to taxable years beginning after December 31, 1941, so as to make such retroactive effect contemporaneous with the effective date of Paragraph (b)(3) as originally added to the Internal Revenue Code.

It is significant that by Section 509(a) of the Revenue Act of 1943, Congress granted an additional period of six months after the expiration of a waiver for taxable years as far back as years beginning after December 31, 1923, in instances where a tax could be assessed only by reason of a waiver. This means that a taxpayer who had given a series of waivers of limitation on assessment for 1924 until June 30, 1949 could file a timely claim for refund of a tax on or before December 31, 1949, although the tax was paid in 1925, while another taxpayer who had given a similar series of waivers but who paid an additional tax for 1924 on June 30, 1949, would also have to file a claim therefor within six months after payment. In the attempt to recognize the equities of the first taxpayer's position, Congress has unintentionally been inequitable to the other taxpayer.

16. The basis of property, acquired by gift but subjected to estate tax in the estate of the donor, should be the same as in the case of property passing by death and not previously made the subject of a gift.

In many cases all or some portion of property held by the decedent as a joint tenant or tenant by the entirety, and property previously transferred by the decedent by gift or in trust, is required to be included in the estate of the decedent for estate tax purposes.

If property is treated, for estate tax purposes, as though it had passed on death, the basis thereof for income tax purposes should be the same as if it had passed on death, namely, the value at which subjected to estate tax. Under present law, though subjected to estate tax, the property's basis for income tax purposes remains the frequently lower cost to the decedent-donor, so that upon a sale of the property at the estate tax valuation, there is also an income tax to be paid.

17. When loss on the sale of property is disallowed by reason of the relation of the parties, the subsequent basis of the property for purpose of determining gain should be the tranferor's basis.

Section 24 (b) of the Internal Revenue Code provides that, in computing net income, no deduction shall be allowed in respect of losses from sales or exchanges of property directly or indirectly, (a) between members of a family; (b) between an individual and a corporation in which he owns (actually or constructively) more than fifty per cent of the outstanding stock; (c) between two corporations when more than fifty per cent of the outstanding stock of each is owned by or for the same individual; and, in the case of trusts, between (d) grantor and fiduciary, (e) beneficiary and fiduciary of trusts, or (f) trusts themselves, if created by the same grantor.

Under present law, if the purchaser in such a transaction thereafter sells at a price higher than he paid, though less than the transferor's cost, taxable gain results. This offends the general principle, applied in many other sections of the Code, that transactions resulting in no recognized gain or loss shall not affect the tax basis of the property.

The Code should be amended to provide that the rule applicable to gifts be applied to such properties and that, for the purpose of determining gain, the cost or other basis of the transferor be the basis to the transferee, but for the purpose of determining losses the basis be limited to the value at the date of transfer. The amendment should also provide that the holding period under section 117 of the Code, in case of gain, shall include the holding period of the transferor.

18. In the case of employees' stock purchase options, there should be treated as compensation income to the employee an amount equal to the spread between the option price and the market value at the time the option right becomes the property of the employee or at the time the employee may first exercise the option, or at the time of exercise or sale of the

option, whichever is the lesser, but in no event should such amount exceed the proceeds of sale of the option, if sold. Such compensation income should not be included in taxable income until the employee sells the stock or option, provided the option price is approximately equal to the fair market value of the stock on the date of the option agreement.

The practice of granting to officers and other employees options to purchase or subscribe for shares of stock in the employer corporation has frequently been used as an incentive. Such employee participation in ownership, with a resulting more direct interest in the success of the corporation, should be encouraged. The rule applied under existing regulations

> "is that an employee exercising an option to purchase stock from his employer corporation receives taxable income at the time the option is exercised to the extent of the difference between the market value of the stock at the time of exercise and the option (or purchase) price. The difference is taxed as ordinary income, rather than as a capital gain, on the theory that it represents additional compensation to the employee. Since the employee does not realize cash income at the time the option is exercised, the imposition of a tax at that time often works a real hardship. An immediate sale of a portion of the stock acquired under the option may be necessary in order to finance the payment of the tax. This, of course, reduces the effectiveness of the employee stock option as an incentive device." (See H. R. Rep. 2087, p. 4, 80th Congress, 2nd Session.)

There should not be taxed to the employee as compensation income more than the amount which is actually realized by the employee and is attributable to the benefit given to the employee by the option. Accordingly, the compensation income should be limited to the difference between the option or purchase price and the market value of the stock at the time the option right becomes the property of the employee (which date is frequently later than the date of the option agreement). Furthermore, such compensation income should not exceed the difference between the option or purchase price and the market value of the stock at the time the option is exercised, and, in no event, should it exceed the proceeds from the sale of the option, if sold. Any subsequent increase in value of the option or of the stock should be treated, upon ultimate disposition of the option or the stock, as a capital gain. The basis for the option should be the amount determined to be compensation income.

In order to induce the employee to retain his stake in the business for a substantial interval, the portion of the gain which is to be treated as compensation income should not be taxed until the ultimate realization of the income by sale of the stock or the option.

If the employee dies before the stock or option is sold, then, under Section 126 of the Code, upon later sale of the stock or option by the estate or heir, the seller would be subject to tax upon the compensation element to the same extent as if the sale had been made by the decedent. If during his lifetime the employee makes a gift of the stock or the option, the compensation element should be taxed to the employee to the same extent as if he had made a sale.

In order to prevent abuse, the amendments should apply only to cases where the option price is not less than, say, 25 per cent below the fair market value of the stock on the date of the option agreement. If the option price is more than 25 per cent below such fair market value, the entire spread should be included in taxable income on the date of the option agreement.

The deduction allowable to the employer corporation for the compensation element should not be postponed beyond the date that the option right becomes the property of the employee. The principle of deferring the taxability of income to the employee, while permitting the deduction of compensation to the employer corporation, is not inconsistent with other provisions of the Code relating to deferred compensation.

19. Section 122(d)(5) provides (for taxpayers other than corporations) for allowance of losses in the computation of net operating loss deduction only if they are attributable to the operation of a trade or business regularly carried on by the taxpayer. The Section should be amended to provide for recognition in the computation of net operating loss deduction of losses on disposal of assets used in a trade or business by a noncorporate taxpayer. Such losses on sales by the estate of a deceased taxpayer, and operating losses by the estate in conducting business, should be allowed as carry-backs to taxable years of the deceased.

In IT 3711 the Treasury Department ruled on the matter of computation of net operating loss deduction of an individual taxpayer who sold at a loss several parcels of real estate operated by her as a source of income. The Department held that such losses were deductible in full by the taxpayer as ordinary losses since the assets constituted property used in trade or business. However it held that the losses were not includible in computation of net operating loss deduction (except to the extent of non-business gross income) on the grounds that while the taxpayer was in the business of operating real estate, she was not in the business of selling real estate. The courts have taken the same position on several occasions.

It seems reasonable to maintain that operating a business comprehends purchasing and selling the related assets, and that losses on sale of such assets are business losses, even if all of the assets are sold and the taxpayer ceases to conduct business. Such losses are presently allowable in determining net operating loss for corporate taxpayers. Section 122(d)(5) should be amended by striking out the words "the operation of" so that the section would not apply to any deduction attributable to a trade or business regularly carried on by the taxpayer.

Section 122 should also be amended to allow a net operating loss deduction on operation and sale of assets by the estate of a deceased taxpayer, to be a carry-back to taxable years of the deceased for the period provided for by the Section.

These amendments should be effective retroactively for all open years.

In support of the asserted position, it should be noted that the report of the Committee on Ways and Means, in amplification of the non-business bad debt provision of the 1942 Act, stated that "a loss incurred in liquidating a business is a proximate incident to the conduct of a business."

20. Recommendations with respect to personal holding companies.

(a) Effectuation of deficiency dividends by consent dividend procedure should be authorized.

Often the finances of the corporation at the time of determination of a personal holding company tax deficiency are such that the payment of a cash dividend to take up the prior deficiency is not possible without seriously disturbing the corporation's financial status. Such a cash deficiency dividend is utterly impossible where the corporation has previously been liquidated. This can be remedied by amending the statute to permit the application of the consent dividend provisions to deficiency dividends.

(b) Deficiency dividend procedure should not be denied in cases of non-fraudulent delinquency in filing personal holding company tax returns.

The provisions of Section 506(f) denying the benefit of the deficiency dividend credit if the final determination of deficiency contains a finding that any part of the deficiency is due to fraud with intent to evade tax, or failure to file the return within the proper time, unless it is shown that such failure is due to reasonable cause and not to willful neglect, should be modified and confined to fraud cases. In many cases personal holding company tax returns have, inadvertently and innocently, not been filed, either because of ignorance, or because of failure to recognize the effect of certain technical provisions, or because of changes in administrative or judicial interpretation of the provisions defining personal holding companies. In some cases changes made by Internal Revenue Agents have caused taxpayers to fall within the personal holding company classifications when clearly, prior to such changes, the filing of personal holding company returns would not have been required. In many such cases, the Commissioner of Internal Revenue has been sustained in his claim that the taxpayer has not shown that the failure to file the return on time was due to reasonable cause and not due to willful neglect, including cases where the fault, if any, lay with the taxpayer's adviser and not with the taxpayer.

Because the cases involving delinquency penalties as a general rule are not serious and involve no element of fraud, the further penalty of a denial of the right to the deficiency dividend credit is unjust. The aggregate penalties might well exceed the fraud penalty in the case of an ordinary corporation. Hence, it is urged that the provisions of Section 506(f) be limited to cases in which all or part of the deficiency is due to fraud with intent to evade tax.

(c) The deduction of the federal income tax, in computing undistributed subchapter A net income, should be clearly stated to be the tax for the taxable year, whether the corporation is on the cash basis or the accrual basis.

Under present law the deduction allowed for federal income tax, in computing undistributed subchapter A net income, is the tax paid or accrued during the taxable year, depending on the taxpayer's method of accounting. In the case of a cash basis corporation the deduction is for any such taxes actually paid during the taxable year, generally consisting of the tax for the immediately preceding year and/or any deficiencies paid for still earlier years. In the case of such a cash basis corporation, which is either newly formed, or which had no income tax for the preceding year, the total tax can and frequently does exceed 100 per cent: e.g., on a $100,000 net income (undistributed), to a cash basis taxpayer the income tax would be $38,000 and the personal holding company tax $84,800, or a total of $122,800.

21. The present double taxation of corporate income—once to the earning corporation, and again to the stockholders upon distribution of such income as dividends—should be mitigated and eventually eliminated. This double taxation has two aspects: (a) tax on intercorporate dividends and (b) tax on dividends paid to non-corporate shareholders without credit either to the corporation or to the shareholder. The tax on intercorporate dividends should be eliminated. Non-corporate shareholders should be allowed a credit against individual income tax of a percentage of dividend income equal to the initial combined rate of normal tax and surtax on individuals, such credit not to exceed the tax, otherwise determined, after applying the credits provided in Sections 31 and 32 but before applying the credit provided in Section 35 of the Internal Revenue Code.

At present, corporate income is subject to a double burden of tax as compared with all other types of income and particularly as compared with business income derived in unincorporated form, such as single proprietorships and partnerships. The duplicate taxation becomes multiple taxation where intercorporate stockholdings and parent-subsidiary corporations are involved, since the corporate income, while passing from the original earning corporation to the ultimate non-corporate stockholders, is subject to tax in the hands of each intermediate corporation in the chain of stock ownership. In addition to the resulting tax inequities, this condition has exerted a disproportionately powerful influence on the selection between corporate and other forms of doing business, has led to unbalanced and unsound financial structures through the substitution of borrowings—the interest payments on which are deductible—for capital stock issues—the dividend payments on which are not deductible—, and has either discouraged, or imposed a tax penalty on—economically necessary and sound parent-subsidiary structures.

This subject, above all others in the field of tax revision, has been distinguished by the fact that almost universal agreement on the desirability of eliminating or mitigating the multiple taxation of corporate income has been at least matched by almost universal disagreement as to the best method of achieving that objective—a disagreement which several years of study and public discussion by many interested groups and individuals have failed to resolve. This committee recommends allowance of a credit for dividends received by non-corporate shareholders as the simplest and most practicable approach to the problem of double taxation of corporate dividends. It is recognized that fiscal requirements of the Government may make impractical, at this time, complete elimination of double taxation of dividends. This committee recommends allowance of a credit, equal to the lowest bracket tax rate applicable to individual incomes.

The credit recommended above will be a partial solution to the inequitable multiple taxation of corporate income distributed to non-corporate shareholders.

22. The 2 per cent additional tax applicable to consolidated returns should be eliminated.

There is every justification for taxing an affiliated group of corporations as the single unit which, economically and in practical fact, it is. This has been recognized as sound accounting and business practice for many years. The principle of consolidated income tax returns is sound because thereby the taxable income of an affiliated group is more clearly reflected than by separate return filing. If it is sound to determine the taxable income of an affiliated group on a consolidated basis, filing on that basis should not be penalized. If such filing is desirable, it should not be discouraged. Determination of taxable income on the basis of the actual business entity—as distinguished from the artificial separate corporate entities—should not be regarded as a privilege to be paid for, but as a desirable objective to be encouraged, or, at least, not discouraged.

23. The "notch" provision under which corporate income between $25,000.00

and $50,000.00 is taxed at 53 per cent as compared with the 38 per cent applicable to income in excess of $50,000.00, should be eliminated, and all corporate incomes, regardless of size, taxed on a graduated rate scale up to $50,000.00, and at a flat rate thereafter, the rate applicable to any income bracket to be no greater than the flat rate.

Under the prevailing rate structure, corporations earning up to $25,000.00 a year pay from 21 to 25 per cent, thereafter 53 per cent on the next $25,000.00, and 38 per cent on the balance of the income. The purpose of the 53 per cent rate in the so-called "notch" bracket (from $25,000.00 to $50,000.00) is to produce an effective rate, equivalent to a flat 38 per cent on the entire income, for incomes exceeding $50,000.00.

The much higher rate for this segment of income is not only unfair but promotes corporate divisions and split-ups and contributes to distortions of income. A method of gradual transition from the lower to the higher rates, comparable to the individual surtax tables, will overcome these conditions.

24. Where a corporation is formed or availed of to acquire the assets and become the successor, in a tax-free reorganization, of a predecessor corporation, which, in pursuance of the plan, is liquidated and dissolved, the successor corporation should step into the "tax shoes" of the predecessor corporation for the purpose of permitting carry-back and carry-forward of net operating losses from one to the other, and application of the tax benefit rule to recoveries by the successor on losses or deductions previously claimed or allowable to the predecessor, and so as to permit full deductibility by the successor of any payments or charges which would have been deductible by the predecessor had the predecessor continued in existence.

Under Sections 112 and 113 of the Code, property acquired by a corporation in certain types of corporate reorganization has the same basis for tax purposes as in the hands of the predecessor company. The underlying theory is that the successor steps into the "tax shoes" of the predecessor company. This theory, however, has not been extended beyond the basis of property except with respect to the status of life insurance as provided in Section 110 of the Revenue Act of 1942. Thus, the Commissioner has not conceded that net operating losses of the predecessor can be carried forward against income of the successor, or vice-versa. Interest paid on additional taxes asserted against the predecessor can be deducted by the successor only to the extent accrued since the date of the reorganization, except possibly in the case of statutory mergers or consolidations. The tax benefit rules provided in Sections 22(b)(12) and 127 of the Code with respect to recoveries on bad debts or taxes or losses or other items previously claimed or allowable to the predecessor is not extended to the successor. Other items of expenses paid by the successor on account of the predecessor, which would have been deductible by the predecessor had it continued in existence, are not allowed as deductions to the successor.

This should be corrected by providing that the successor in such cases succeeds to the tax status of the predecessor for the purposes above mentioned.

The principle asserted above should be made applicable to all transactions recognized as tax free under Section 112 of the Internal Revenue Code, including complete liquidations of corporations under subsection 112(b)(6). The corrective amendment should be made applicable retroactively to all taxable years not barred by limitation or closing agreement.

25. For the purpose of Section 23(g)(4), which excludes from the capital loss category, loss from worthlessness of stock in a virtually wholly owned subsidiary of a domestic corporation, if more than 90 per cent of the subsidiary's gross income for its entire history was from other than investment sources, gross income from the sale of merchandise, stock in trade, or property held primarily for sale to customers in the ordinary course of the trade or business, should be defined to mean "gross receipts" from such sales.

Broadly speaking, it was the purpose of Section 23(g)(4) to permit an ordinary loss deduction for loss from worthlessness of stock in a bona fide operating subsidiary, with no substantial investment income. This purpose is defeated where the subsidiary's operations are so disastrous that it has a gross loss on its sales, and therefore no gross *income* therefrom, since in such case an utterly insignificant amount of investment income would be more than 10 per cent of the gross income and would remove the case from Section 23(g)(4), requiring treatment of the loss as a capital loss. This should be remedied by defining gross income from sales, for this purpose, as "gross receipts" from sales. This amendment should be made applicable retroactively to all open years.

26. A transfer of substantially all the assets of a corporation to another corporation should not be disqualified as a "reorganization" under Sec-

tion 112(g)(1)(C) merely because the voting stock received in exchange is that of a parent company of the transferee corporation.

In *Groman* v. *Commissioner,* 302 U.S. 82 and *Helvering* v. *Bashford,* 302 U.S. 454, the Supreme Court held that where all the assets of one corporation were transferred to another company for its stock, and such properties were then transferred to a subsidiary of the company issuing the stock (or were transferred directly to such subsidiary in the first instance), the company issuing the stock was not a "party to the reorganization" and the receipt of its stock by the shareholders of the company whose properties were acquired was a taxable exchange—and not, as in most mergers, an exchange on which gain or loss is not recognized. Such transfers should qualify as tax-free reorganizations to the same extent as if the stock-issuing company had no subsidiary and retained the properties itself—the transfer to such subsidiary being purely an internal arrangement of the stock-issuing company. This condition can be remedied by extending the term "party to a reorganization" to include the parent corporation owning all of the stock of a corporation to which the properties are transferred.

27. The definition of reorganization in Section 112(g) should be broadened to bring within its scope "spin-off" and "split-up" transfers.

The definition of reorganization should be amended to permit the distribution, pursuant to a plan of reorganization, to a shareholder of a corporation a party to the reorganization, of stock in such corporation or in another corporation a party to the reorganization without surrender by the shareholder of stock in the distributing corporation. Enactment of this change will facilitate corporate readjustments by removing the present requirement that stock in the distributing corporation be surrendered in the course of such a reorganization.

The definition of a reorganization in Section 112(g) should be clarified to remove any doubt that an exchange, pursuant to a plan of reorganization, of shares in a corporation by its shareholders for stock of two or more corporations formed to acquire the assets of such corporation is a reorganization.

28. Recommendations re mitigation of effect of statute of limitations.

The purpose of Section 3801 was to mitigate the effect of the statute of limitations since "It was never intended that the statute of limitations should have the result of allowing either taxpayer or Commissioner to reap a double advantage from its operation by assuming in one year a position inconsistent with that taken in a barred year."

Section 3801, as enacted, has limited application since (1) only income and profits taxes under Chapter 1 and subchapters A, B, D and E of Chapter 2 may be involved, (2) the error and the determination, as defined by Section 3801(a), must relate to the same type of tax as enumerated in (1) above; (3) the determination and error must relate to the situations specified in Section 3801(b). These limitations restrict the benefits to be derived from this Section and do not relieve the hardship in many meritorious situations, those falling outside these specific types of cases continuing to rest on general principles. For example, if the Commissioner shifts an item of income from a barred year to an open year, or a deduction from an open year to a barred year, the taxpayer in equity and good conscience should be entitled to a refund for the barred year. The Commissioner at present has no power to grant the refund. Another class of situation involves an adjustment for one taxpayer because of another taxpayer's error.

The law should be amended to cover the following:

(1) When a deduction is made in good faith on the tax return of one year and is disallowed by the Commissioner on the ground that it was deductible in a return of a different year.

(2) When income is included by the taxpayer in good faith in one year and is held by the Commissioner to be taxable in another year.

(3) When the basis of an asset claimed by taxpayer is reduced by the Commissioner for the purpose of computing net income of one year on the ground that the reduction of the basis should have been made in another year.

(4) When income or deductions are included or deducted by one member of an affiliated group, as defined in Section 141(d), and are allocated by the Commissioner to another member of the group.

(5) When income or deductions are included in good faith in the tax return of one taxpayer but are adjusted by the Commissioner because of another taxpayer's error.

(6) When income or deductions are included in good faith on the tax return of one taxpayer and adjustments are made by the Commissioner in respect to a related taxpayer under the provisions of Section 45.